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IRS News Release

Media Relations Office **Washington, D.C.** **Tel. 202.622.4000**
For Release: 4/02/01 **Release No: IR-2001-42**

IRS PROVIDES ADDITIONAL GUIDANCE FOR NEW MEXICO FIRE VICTIMS

WASHINGTON – The Internal Revenue Service, which two weeks ago provided victims of the Cerro Grande Fire an extra nine months to file and pay federal taxes, today gave additional guidance on the proper tax treatment of losses and payments related to this disaster.

“Last summer’s law providing special payments to the victims of this disaster did not address the tax implications of that relief,” said IRS Commissioner Charles O. Rossotti. “Our National Office attorneys have worked with IRS employees, FEMA staff and tax preparers in New Mexico to identify and answer various questions that have been raised. This guidance supplements what taxpayers will find in our existing publications on disaster situations.”

The guidance is summarized in the attached series of questions and answers.

The extra time for filing and paying applies to income, employment, estate, gift and certain excise taxes for individuals and businesses. It covers returns and payments that were due from May 4, 2000 – the day the fire started -- through April 16, 2001, the due date for individual income tax returns.

Affected taxpayers are generally those whose principal residence or principal place of business is located in one of the 21 counties of this federal disaster area: Bernalillo, Chaves, Cibola, DeBaca, Dona Ana, Eddy, Guadalupe, Lincoln, Los Alamos, McKinley, Mora, Otero, Rio Arriba, San Juan, San Miguel, Sandoval, Santa Fe, Sierra, Socorro, Taos, and Torrance.

For example, individuals living in the disaster area will have until Jan. 16, 2002, to file and pay their income taxes for 2000, without interest or penalties on the balance due.

Taxpayers relying on this relief should put the words “CERRO GRANDE FIRE” in red at the top of any returns filed. They do not have to file any separate extension request.

The IRS continues to offer tax help regarding this disaster through its Cerro Grande Tax Information Hotline at 505-661-8235.

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QUESTIONS & ANSWERS
CERRO GRANDE FIRE DISASTER AREA

GENERAL QUESTIONS

Q1. When is my tax return due?

The time for filing income tax returns for tax year 2000 by an individual with his or her principal residence in 21 specified counties in New Mexico has been extended by Notice 2001-30, 2001-14 I.R.B. 989. These returns would ordinarily be due on or before April 16, 2001 (April 15, 2001, is a Sunday), but are now due on or before Wednesday, January 16, 2002. Taxpayers do not need to file a form requesting an extension of time to file. Taxpayers should write the phrase “Cerro Grande Fire” in red ink at the top of their returns. In addition, Notice 2001-30 extended the time to pay the tax (or installment of tax) shown or required to be shown on these returns until January 16, 2002. Underpayment interest and penalties will not be due on a payment made on or before January 16, 2002.

The time for electing to deduct your losses from the fire on an amended 1999 return is extended 90 days from April 16, 2001, that is, until July 16, 2001. Alternatively, you may deduct your losses on your year 2000 return, due January 16, 2002. See also, Q5 through Q7.

The time for filing returns other than individual income tax returns by taxpayers in the 21 specified counties in New Mexico has also been extended by Notice 2001-30. This extension applies to returns required to be filed on or after May 4, 2000, and on or before April 16, 2001. The extension is for six months and for 90 days. The affected returns include corporation income tax returns, partnership returns, estate and trust income tax returns, annual returns filed by tax-exempt organizations, certain excise tax returns, and employment tax returns. Therefore, a calendar year corporation income tax return for tax year 2000 originally due on or before March 15, 2001, is timely if filed on or before Monday, December 17, 2001.

Taxpayers do not need to file a form requesting an extension of time to file. Taxpayers should write the phrase “Cerro Grande Fire” in red ink at the top of their returns. In addition, Notice 2001-30 extended the time to pay the tax (or installment of tax) shown or required to be shown on these returns until the new due date. Underpayment interest and penalties will not be due on a payment of **income tax** made on or before the new due date. Penalties will not be due on a payment of tax other than income tax made on or before the new due date. However, underpayment interest will be due on a payment of tax other than income tax made after the original due date.

Q2. I received money from FEMA last year because of the fire. Now I've heard that I may receive a Form 1099. Do I need to include this amount on my return?

FEMA made reimbursements for a wide range of claims. In order to determine whether any of these amounts are taxable, you first need to know what the payments you received were for. Some of the more common taxable payments for which you may receive a Form 1099 are discussed below.

1. Wages you lost because you could not work, including payments to a member of a Pueblo. These amounts are included in income along with your other wages on your tax return.

2. Lost business income. These amounts are included with other business income on your tax return.

3. Payments to a member of a Pueblo for lost business income. These reimbursements are generally includible in income, unless lost income would have been derived from the land.

4. Payments to a member of a Pueblo for lost sales of artifacts to tourists. These amounts are taxable and are included with other income.

For other payments, you may not receive a Form 1099. The following questions discuss other payments you may receive.

Q3. Are personal living expense reimbursements received from my insurance company or from FEMA taxable? I received a lump sum payment.

You do not need to include in income reimbursements for personal living expenses, whether these payments are made by your insurance company or by FEMA, so long as the payments relate to necessary or additional expenses directly attributable to the disaster. This exclusion does not extend to amounts received for luxuries, or for living expenses if you have abandoned efforts to re-occupy a dwelling comparable to the one destroyed by the fire.

If the payments compensate you specifically for medical expenses, you must reduce any deduction you take for medical expenses by this amount.

Q4. Are reimbursements received for claim preparation expenses included in my income?

Although reimbursements for claim preparation expenses are treated as additional amounts received from FEMA, you may reduce the total amount received by your claim preparation expenses in determining your gain, if any, on damaged or destroyed property.

HOMEOWNERS

Damage to principal residence: casualty loss deductions

Q5. I lost my home and personal use property. If I have not been fully reimbursed, do I have a deductible loss and, if so, when should I declare a loss on my tax return?

If you have a reasonable prospect of being reimbursed for some part (or all) of your casualty loss, you must reduce the amount of the tax loss you claim in the year of the casualty by the amount of the expected reimbursement. Because there is a reasonable prospect of your receiving payment of a claim that you file with FEMA, you should reduce any tax loss that you claim for the destruction of your home and property by the amount of your FEMA claim.

If you are unable to claim a tax deduction in the year of the fires due to your having a reasonable prospect of being reimbursed, you can deduct the loss in the year in which you no longer have a reasonable prospect of recovery. If you are reimbursed, but in an amount less than the amount of your loss, you can only deduct the amount by which your actual loss exceeds the amount of your reimbursement.

If you do not have a reasonable prospect of being reimbursed for some part (or all) of your loss, you can claim a tax deduction for this amount in the year in which the casualty occurs. Alternatively, because your loss occurred in a Presidentially declared disaster area, your loss may be claimed on an amended return for the prior year to the extent there is no reasonable prospect of recovery when the deduction is claimed.

Q6. I lost <u>real property</u> that I used for my <u>personal use</u>. It was not used in business and was not held for investment. How should I treat my loss?

You treat the entire property (land including any improvements such as buildings, trees, and shrubs) as one item. Do not separate the basis in the land from the basis in the building.

Your loss after reimbursement is figured using the following steps:

1. Determine your adjusted basis in the property before the casualty. Your adjusted basis generally is the price that you originally paid for the property.

2. Determine the decrease in fair market value (FMV) of the property as a result of the casualty.

3. From the smaller of the amounts you determined in 1 and 2, subtract any insurance or other reimbursement you received or expect to receive.

You add this loss to all other gains and losses caused by the fire before applying the $100 limitation and the 10% limitation rules. You will use Form 4684 and Schedule A to report your loss.

The $100 rule is applied only once for a single event (such as the Cerro Grande Fire), even if many pieces of property are damaged or destroyed. The 10% rule applies once to each tax year.   Guidelines for applying these rules can be found in Publication 547, Casualties, Disasters, and Thefts.

Guidelines for determining your adjusted basis can be found in Publication 551, Basis of Assets.

Q7. I elected to deduct my loss by amending my prior year tax return. I did not know that I would be reimbursed for my loss at the time I filed the amendment. What should I do now?

You should calculate your loss deduction based on the facts existing at the time you complete your tax return. If, at that time, you believe you have a reasonable prospect of being reimbursed for your loss, you must reduce your loss deduction by the amount of the expected reimbursement (if any). If you receive less reimbursement than you expected, include the difference as a loss on your return for the year in which you can reasonably expect no more reimbursement.

If, instead, you have claimed a loss and later receive more reimbursement than you expected, you may have to include the extra reimbursement in your income for the year you receive it. However, if any part of the original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement in your income. Publication 525, Taxable and Nontaxable Income, has a worksheet for Recoveries of Itemized Deductions to assist in determining the amount of your recovery to include in income.

Damage to principal residence: reimbursements, gain, exclusion, and deferral of gain.

Q8. I received payment from my insurance company or FEMA for my damaged or destroyed principal residence or personal property. How do I treat these payments?

If you receive compensation from your insurance company or from FEMA under the Act that exceeds your adjusted basis in the house, you have gain. This gain generally is includible in gross income. A homeowner may exclude some or all of the gain on a principal residence from income if the homeowner has owned and used the property as the principal residence for periods aggregating 2 years or more. The amount of gain you may exclude generally is limited to $250,000, but, in certain cases, married couples on joint returns may exclude up $500,000 of gain. You may not exclude gain, however, if, in the 2-year period ending on the date of the destruction of the home, you have applied this exclusion to any other sale.

You may elect to defer any additional gain by replacing your house with one costing at least as much as you receive from insurance.

Q9. Does gain result from insurance proceeds I received for unscheduled personal property not located in my home that was destroyed in the fire?

You may exclude gain resulting from insurance proceeds received for unscheduled personal property not located in your home that was destroyed in the fire.

Q10. As a homeowner, are reimbursements from FEMA for the cost of my flood insurance premiums included in my income?

You do not have to include in your income a payment from FEMA under the Cerro Grande Fire Assistance Act to cover your expenses of paying a flood insurance premium for your home.

BUSINESS OR HOME: POSTPONING GAIN ON RECEIVING COMPENSATION FOR YOUR LOSS

Q11. How do I make an election to postpone the gain that results from receiving payments for my damaged or destroyed property?

If you have a gain from insurance proceeds or FEMA payments received for property, other than unscheduled personal property, that was destroyed in the fire, you may elect to postpone reporting the gain in income. (Any gain you have on proceeds or payments received for unscheduled personal property is not taxable, so you do not need to elect to postpone that gain.) The election is made by not including the gain in income on your return for the year in which you have the gain. You should include all of the details concerning the involuntary conversion in a statement you attach to your return.

If you make an election to postpone the gain, you will need to purchase qualifying replacement property within the replacement period. Qualifying replacement property generally is property that is similar or related in service or use to the property that was destroyed. The replacement period generally runs for two years following the year in which you have the gain, but if necessary you may request additional time from your local IRS office. You should attach additional statements to your returns for the year or years in which replacement property is acquired that provide details about the property you acquired and its cost.

The amount of the gain that you may postpone depends on how much you spend on the replacement property. If the cost of the replacement property is more than the insurance proceeds or FEMA payments you received, then all of the gain may be postponed. Otherwise, the gain is recognized to the extent that the amount of the proceeds or payments exceeds the cost of the replacement property. You keep track of the postponed gain by subtracting it from the basis, which is generally the cost, of the replacement property. When the replacement property is later sold, the lower basis is used in calculating how much gain you have on the sale.

Q12. What do I do if I make an election to postpone the gain and later decide not to replace the destroyed property with replacement property?

You will need to amend your return for the year in which you had the gain and include it in income on that return.

Q13. I have decided not to elect to postpone the gain. What is the tax effect of this decision?

You include the gain in income on your return for the year in which you have the gain. Use Form 4684, Casualties and Thefts.

BUSINESS QUESTIONS

Q14. I elected to deduct my loss on business property by amending my prior year tax return. I now realize that the total of all the reimbursements I have received or expect to receive will be more than my adjusted basis in my destroyed property. What should I do?

You are entitled to deduct as a tax loss the amount of your investment in the destroyed business property (your “adjusted basis”). Your adjusted basis generally is the price that you originally paid for the property, reduced by the amount of depreciation you should have claimed on the property. If the total payments that you receive as a result of the property’s destruction is more than your adjusted basis in the property, you must report the additional amount as taxable income. You cannot claim a loss deduction for the amount by which you are or expect to be reimbursed. If you have already claimed a loss deduction for the destroyed property because you had no reasonable prospect of recovery and you are reimbursed for the loss in a later year, you may have to include the amount of the reimbursement in your income for the later year. You should report the reimbursement as ordinary income (line 21, Form 1040) up to the total amount of your earlier loss deduction (to the extent the deduction reduced your tax for the earlier year).

If you receive reimbursements totaling more than the amount of the earlier loss deductions that you claimed, and if you do not choose to postpone recognizing the gain, report the excess amount on Form 4684 and Schedule D.

You may be able to postpone the gain using the rules for involuntary conversions or the special rules applicable to the disposition of property used in a trade or business (so-called “section 1231 property”). Publication 544, Sales and Other Dispositions of Assets, can help you determine how to apply these rules.

Q15. How do I account for payments from insurance or FEMA for losses of inventory in my business?

The decline in value of your inventory caused by the fire will be automatically reflected in cost of goods sold by properly reporting purchases, opening and closing inventory (closing inventory will reflect loss due to the fire). Losses accounted for through cost of goods sold in this manner may not be separately deducted as a casualty loss. When using this method, any insurance or other reimbursement must be included in gross income in the year received or accrued.

If you deduct the loss separately, rather than accounting for it through cost of goods sold, opening inventory or purchases must be reduced by the amount of the casualty loss that you claim. You should determine your casualty loss and include reimbursements in income in the same manner described in Q14.

If you elect to postpone any gain on the inventory due to the fire, using the involuntary conversion rules discussed in Q11 through Q13, above, the gain would be recognized only to the extent that the amount received or accrued exceeds the cost of similar property that you acquire to replace the destroyed inventory. The tax basis of the replacement property must be reduced by the amount of the gain not recognized. The gain recognized is ordinary.

Q16. Since the reimbursement of my lost business income is included in with my other business income, do I need to pay self-employment taxes on these reimbursements?

Yes, these reimbursements are includible in self-employment income and subject to self-employment tax.